

## **Exchange Traded Funds are becoming smarter**

by Mark Vallon

**In the past Exchange traded Funds were used predominantly to replicate market performance (Beta). Today's ETFs are however also able to generate a consistent beta plus performance. Investors can clearly benefit from a drift from a traditional passive strategy. However it is important to understand the distinct features and potential disadvantages.**

Today's investor has the choice between market returns (or "beta") and outperformance ("beta plus"). Although active ETFs are still rare, there are a growing number of passive ETFs that aim to outperform established benchmarks. These are increasingly known as 'smart beta' or 'beta plus'. The distinct feature is that they are based on a underlying that aims to outperform the broad benchmark. One example is an ETF, which is designed to outperform the broader European equity market by capturing alpha from broker buy/sell recommendations. Hence, within the ETF world, the search for outperformance may not mean buying an actively managed product. There are also many opportunities for investors in passive 'beta plus' products.

The most important difference between active and passive ETFs is the need for investment expertise. Many ETF issuers are passive managers who may not have active investment expertise in-house. An opportunity for passive ETF managers is to partner with managers with differentiated active management skills. This partnership can create value for both parties as traditional active manager may not have the operational expertise to manage an ETF and organise the creation of an active secondary market. Investors in active ETFs should ensure that the manager operating the ETF has a holistic solution.

### **The Requirements must be met**

It is common knowledge that many active managers fail to beat their benchmarks. This is no surprise. Active managers and 'beta plus' indices are likely to succeed only in certain circumstances or market segments. When markets are highly correlated, or when all investors have access to the same information, it is difficult to outperform passive investments in standard, established benchmark indices.

An example can provide a good illustration of how a value-added approach can work: To create a European equity index, high quality buy/sell recommendations sent by leading brokers to the beta-plus index sponsor. Because this index is exclusive – not all

investors have access to the same broker ideas – it has the potential to outperform the broader market.

Another area where active management makes particular sense is the fixed income market. Firstly, fixed income benchmarks can be difficult to replicate, with many potentially illiquid constituents. Secondly, investors are increasingly concerned about credit risk, so a manager's ability to vet individual securities – rather than blindly following a benchmark – is very valuable. And finally, when yields are very low, an active manager may be able to find opportunities to enhance returns. In the US ETF market, most active ETF assets are in fixed income.

### **What are the pros and cons of active ETFs?**

ETFs are known for their liquidity, transparency and operational efficiency. Can investors expect these advantages from active and beta plus ETFs too? Intra-day liquidity is a defining feature of ETFs. Are active ETFs less liquid than passive ETFs? Not necessarily. The liquidity of an individual ETF depends on the liquidity of the underlying exposure and the involvement of committed market makers. An actively managed European equity ETF may be significantly more liquid, with tighter bid-offer spreads, than a passive ETF with exposure to less liquid markets.

Nonetheless, transparency represents a greater challenge for active ETFs. Although investors can expect full transparency around fees and costs, transparency around fund constituents may pose challenges. There is a good reason for this. Providing real-time fund constituents would allow someone to replicate an active strategy, without paying the management fee. More importantly, transparency around positions can create trading activity that is detrimental to the strategy. Active strategies typically have limited capacity and may take contrarian positions. Their potential to generate outperformance could disappear if too many traders were targeting the same opportunities. Active managers have to consider all these issues when considering launching an ETF on a compelling strategy.

Active ETFs may charge higher fees than a passive ETF in a similar market segment. However, the most important consideration is whether the manager is generating enough value to justify the extra fee. Consistent outperformance is key to justifying and absorbing higher fees. This takes us back to total cost of ownership. If the fund outperforms its benchmark, after taking into account all costs, then it justifies its charges.

Finally, it is important to remember that an ETF is simply an investment vehicle and not an asset class. There is no guarantee that active ETFs, or 'beta plus' passive ETFs,

will deliver greater outperformance than traditional mutual funds. However, the transparency and flexibility of ETFs allows investors to evaluate performance continuously and adjust their positions more efficiently.

#### **About the author**



*Mark Vallon* is responsible for coverage of institutional clients in Switzerland & Liechtenstein. Prior to joining Source, Mark was a sales director at BNP Paribas Investment Partners in Zurich where he was responsible for fund distribution to private banks, asset managers, life insurers and family offices in Switzerland. Previously, Mark worked at UBS Wealth Management where he managed sales-related projects targeting Swiss private and corporate clients. Mark also spent over five years covering private clients in Switzerland and the United Kingdom having started his career as part of the UBS apprenticeship programme. Mark holds a Bachelor of Science in Business Administration from HWZ University of Applied Sciences in Zurich.

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